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October 25, 2010

Françoise Flores, Chairman  
EFRAG

Re: EFRAG Draft Comment Letter - Exposure Draft Insurance Contracts

Dear Sir Françoise Flores

The purpose of this letter is to provide the EFRAG with a list of critical issues and remarks regarding the margin approach of the exposure draft and the corresponding response of EFRAG to questions 2 and 4.

The following remarks and issues are mainly obtained from the point of view of a direct property and casualty insurer.

- C1 One aim of the exposure draft (paragraph 35) is to reflect within the risk margin a good approximation of

“... the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.”

If there were a real market for insurance liability risk the risk margin would therefore represent the corresponding market price. But, because of the absence of a real market for insurance liability risks, it is in most cases impossible to fulfil the stated requirements on a risk margin. Although, one can assume that the proposed risk measures (paragraph B73 ff) would in most cases reflect the time development of the marked price of insurance liability risks they cannot be calibrated in such a way that they can be used as good approximation of the marked price. Therefore, all of them do not fulfil the board's definition of a risk margin.

- C2 Diversification is one of the reasons for the profitability of insurance companies (and maybe the major reason for the existence of insurance at all). Therefore, an investor would prefer an insurance company to use the effects of diversification extensively. Since paragraph 36 does forbid diversification between portfolios the amount of the overall risk margin heavily depends on the granularity of the underlying portfolios which makes the comparison between different insurance companies of the same nature complicated and may confuse users of the financial statements.

For illustration see the following examples. Consider two similar insurance companies A and B.

- If A reports its financial statements on a quarterly basis it may group all initially recognised contracts of a quarter into portfolios. Furthermore, assume that B reports

only once a year and therefore groups all initially recognised contracts of a year into portfolios. Then A cannot take diversification between quarters into account. This will lead to a higher risk margin for company A than for company B.

- Assume both companies have similar contracts and that A bought reinsurance for some contracts and consider such reinsured contracts as a standalone portfolio whereas B does not. Then, A cannot use the diversification between the reinsured and the other contracts. This may lead to a higher gross risk margin than the one of B and in some situations even the net risk margin of A may be higher than the one of B.

C3 The term portfolio is used within several paragraphs of the exposure draft, for instance 20, 23, 36, 69, B61, B63, B65, B66 and Appendix A, but it is not clear whether or not they refer to the same object. Moreover, it is not clear if it is allowed to regroup insurance contracts into portfolios over time. For instance, assume we have two portfolios A and B. Portfolio A contains contracts that have been initially recognised in previous reporting periods and portfolio B contains similar contracts as portfolio A that have been initially recognised in the current reporting period. In order to take diversification effects into account, see in addition comment C2, an insurance company would like to join both portfolio immediately after initial recognition of portfolio B.

If such regrouping is allowed it will lead to gains or losses that will be hard to understand for users of the financial statements, in particular if they result in day-one gains. Therefore the final standard should contain a more precise guidance on portfolios.

C4 In general I share the boards opinion about the importance of a risk margin for the understanding of insurance liabilities. But I do not believe that the proposed three building blocks approach will lead to a practicable and consistent (over time for each entity and between different entities of similar nature) representation of non-life insurance liabilities. The main problem lies within the remeasuring on the risk margin at each reporting period. We believe that it would be better to initialise margins at initial recognition and estimate their development afterwards.

An alternative to the presented margin model may be one of the following approaches:

**Two margin approach:**

A1 An insurance company has to group its contracts into portfolios as defined within Appendix A of the exposure draft. This grouping is not supposed to change over time and new contracts have to be added into one of those portfolios. Details about the grouping of contracts have to be disclosed.

A2 For each portfolio the insurer chooses two appropriate risk measures (see paragraph B73) that are not supposed to change over time. One should be used for initial recognition (initial risk measure) and the other should be used for remeasuring (remeasuring risk measure). Details about the chosen risk measures have to be disclosed. The resulting amount of a risk measure applied to the discounted cash flows of a (sub) portfolio is called the corresponding risk magnitude of the (sub) portfolio.

A3 At the end of each reporting period take the initial risk measure in order to calculate the risk magnitude for the initially recognised contracts of each portfolio (RMI). The

risk margin of this subportfolio is set to the risk magnitude and the residual margin of this subportfolio is defined by the principle of denying day-one gains.

- A4 The residual margin is released as proposed by the exposure draft (paragraph 50).
- A5 At the end of each reporting period the remeasuring risk measure is used in order to calculate the risk magnitudes for the whole portfolio and for the subportfolio of all contracts, which does not have been initially recognised during the reporting period. We refer to the first risk magnitude by RMA and to the second one by RMO.
- A6 For each portfolio we calculate the risk margin (RM) for the subportfolio of all contracts that have been initially recognised during previous reporting periods as the product of the risk margin of the whole portfolio as at the end of the last reporting period and the RMO of the current reporting period divided by the RMA of the last reporting period.
- A7 The total risk margin of a portfolio is the sum of the risk margins calculated in A3 and A6.
- A8 Allocation of the risk margin to subportfolios is done proportionally to the corresponding risk margins calculated by the remeasuring risk magnitudes.
- A9 The confidence level that corresponds to the total risk margin of a portfolio has to be disclosed.

#### **Single margin approach:**

- P1 An insurance company has to group its contracts into portfolios as defined within Appendix A of the exposure draft. This grouping is not supposed to change over time and new contracts have to be added into one of those portfolios. Details about the grouping of contracts have to be disclosed.
- P2 For each portfolio the insurer chooses an appropriate risk measure (see paragraph B73) that is not supposed to change over time. Details about the chosen risk measure have to be disclosed. The resulting amount of a risk measure applied to the discounted cash flows of a (sub) portfolio is called the corresponding risk magnitude of the (sub) portfolio.
- P3 At the end of each reporting period the risk measure is taken in order to calculate the risk magnitudes for the whole portfolio and for the subportfolio of all contracts, which does not have been initially recognised during the reporting period. We refer to the first risk magnitude by RMA and to the second one by RMO.
- P4 For each portfolio the composite margin (CMN) for the subportfolio of all during the reporting period initially recognised contracts is defined by the principle of denying day-one gains.
- P5 For each portfolio we calculate the composite margin (CMO) for the subportfolio of all contracts that have been initially recognised during previous reporting periods as the product of the total composite margin of the whole portfolio as at the end of the last reporting period and the RMO of the current reporting period divided by the RMA of the last reporting period.
- P7 The total composite margin of a portfolio is the sum of CMN and CMO.

P5 Allocation of the composite margin to subportfolios is done proportionally to the corresponding risk magnitudes.

P8 The confidence level that corresponds to the total composite margin of a portfolio has to be disclosed.

Sincerely,

René K. Dahms